



State of New Jersey

DEPARTMENT OF THE TREASURY
DIVISION OF INVESTMENT
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March 12, 2010

MEMORANDUM TO: The State Investment Council

FROM: Ray Joseph
Acting Director

A handwritten signature in black ink, appearing to read "Ray Joseph".

SUBJECT: **Investment Plan for Fiscal Years 2010-2011**

Enclosed is our proposed Annual Investment Plan for the remainder of FY2010 and for FY2011. This Plan has been reviewed by the Investment Policy Committee, and is presented for acceptance to the State Investment Council.

Please note that implementation of this plan will not require changes to Council regulations or policies.

The major changes from the FY2009 Investment Plan are: 1) a reduction in large cap US and developed international equities to improve the overall risk-return profile of the Fund, with an increase in small cap and emerging market equities; 2) an increase in the fixed income allocation, mainly within the corporate and Build-America-Bond sectors, which continue to offer attractive risk-adjusted returns; and 3) an increase in Hedge Funds and Commodity/Real Asset related investments.

Overall, the objective of this plan is continue to improve the Fund's overall diversification and to allow the Division to achieve its long-term return objectives during today's low-yield environment with less reliance on traditional public equities to drive returns. We will continue to search for tactical opportunities to improve the Fund's risk-adjusted returns and to complement our long-term strategic objectives.

We believe the markets will present compelling investment opportunities in many sectors of the alternative investment environment and would like greater flexibility to pursue these opportunities over the long term. The Division continues to allocate a greater percentage of the portfolio to alternative investments. This greater allocation to alternatives will be balanced in a dynamic fashion between liquidity to meet benefits obligations and existing private investment commitments, and returns from committing to new alternative investments. We expect the beneficial impact of alternative investments to continue to improve the Fund's risk-adjusted returns.

FY2010-2011 Investment Plan Outline

Overview

- This investment plan is for the remainder of FY 2010 and for FY 2011.
- Investment assumptions for each asset class (long-term expected returns, volatilities and correlations) are provided by the Division's general consultant, SIS, and presented in Exhibit 1. Assumptions are somewhat different than those used in the FY2009 Investment Plan, reflecting the significant changes in market conditions since late 2008. In particular:
 - We decreased the assumed returns on public equities by about 50 bps to reflect the 2009 market rally, and we also modestly increased assumed volatility.
 - We reduced expected returns on long-duration fixed income by about 50 bps. While bond yields have decreased more dramatically than this reduction would indicate, the sharply upward-sloping yield curve adds to the NJDOI expected return due to the Division's long-duration posture; expected risk has been increased substantially, by about 3%.
 - High yield expected returns have been reduced by 150 bps due to the strong rally these bonds have experienced over the past year.
 - We increased the assumed return on hedge funds by 50 bps to reflect an improvement in the investment environment for absolute return strategies, the initial funding of global macro, and the availability of leverage gradually improving.
- Our proposed asset allocation and the resulting portfolio shifts are presented in Exhibits 2-3. We present two separate allocation views: Exhibit 2 ("Target Allocations") presenting near-term targets for the various alternative investment subcategories and Exhibit 3 ("Range Allocations") presenting the current maximum 7% target for each sub-category, reflecting statutory limitations as well as the overall 28% alternatives limitation.

It is our opinion that the Fund would benefit from greater investment flexibility by regulatory changes that would increase the 28 percent top end of this range, positioning the Division to take advantage of attractive near-term investment opportunities and maximize the Fund's long-term risk-adjusted returns. The Division remains substantially overweight relative to the FY2009 ranges in public equities, and underweight in inflation-sensitive and alternative investments.

- During FY2009, initial investments were made to emerging markets and high yield debt through the use of external advisers to assist the Division staff who manage these portfolios. The planned initial allocation to small cap equity, however, was not implemented. Our proposed allocations to each of these

subcategories have been increased as part of this plan, consistent with the objective of gradually building exposure to these areas over the long term.

- Within Alternatives, it was expected that by June 2010 the Division would have reached or slightly exceeded the Council's original long-term midpoint allocations on an invested basis: 5.5% for private equity, 4% for real estate and 6% for hedge funds. In actuality, while private equity has already exceeded this midpoint and is expected to approach its 7% limit, real estate and hedge funds are still below these initial midpoints.

This plan incorporates no change to the current private equity target of 5.5%, but recommends an increase in the hedge fund target from 6% to 6.75%, reflecting attractive investment opportunities in this space, and a corresponding reduction in the real estate midpoint from 4% to 3% to accommodate these changes (though the Plan's actual real estate exposure is still below 3%). The Commodities midpoint is increased from 3% to 4% (the current allocation is about 1.5%). FY 2010-2011 commitments to private equity and real estate are expected to be well below the investment pace experienced in 2005-2007, though the Division may move towards the upper end of its allowable investment range should market conditions and overall fund values permit.

- The major changes from the FY2009 Investment Plan are: 1) a reduction in large cap US and developed international equities to improve the overall risk-return profile of the Fund, with an increase in small cap and emerging market equities; 2) an increase in the fixed income allocation, mainly within the corporate and Build-America-Bond sectors, which continue to offer attractive risk-adjusted returns; and 3) an increase in Hedge Funds and Commodity related investments.
- Overall, the objective of this plan is continue to improve the Fund's overall diversification and to allow the Division to achieve its long-term return objectives during today's low-yield environment with less reliance on traditional public equities to drive returns. We will need to balance the need for maintaining liquidity for benefits payments with allocations to private investments.
- The benchmarks for all asset classes will remain the same as in current use, with the exception of the benchmark for International Developed Market and Emerging Market equities, as discussed below.

Public Equities – US (Large and Small Cap)

- We are proposing a continued reduction in this portfolio, which has served as the primary source of funds for our alternative investment portfolio.
- We may be able to utilize external advisers for a portion of the US small cap portfolio as a means to supplement the activities of Division staff; should this not

be possible, we will consider alternate ways to gain small cap exposure or redeploy these dollars by creating a sub-portfolio within the US Equities portfolio (A fund), or by using ETFs.

- Return expectations for US Large Cap and Small Cap stocks has decreased by roughly 25-50 bps from last year. This reflects a decrease in the equity risk premium, as we believe the equity market rally during 2009 has reduced the attractiveness of public equities.

Public Equities – International Developed Markets

- As with US equities, the allocation to international equities will be reduced. The developed market portfolio will continue to be internally managed.
- Return expectations for International Developed stocks has decreased by 50 bps from last year. We continue to expect developed markets to perform in line with the US market in local currency terms; we do not have a strong view regarding the dollar so we have not factored in a currency related return adjustment.

Public Equities – Emerging Markets

- We propose to increase this allocation from current levels due to the proposal of a new international equity benchmark. We intend to propose a transition from using separate MSCI EAFE and Emerging Market benchmarks for the developed and emerging market equity portfolios to the MSCI All-Country World ex-US benchmark, adjusted for those companies which are prohibited under the Sudan and Iran laws, for all non-US equities. This benchmark change will result in a doubling of the allocation to emerging market equities as a percentage of total non-US equities, from about 10% to 20%. As a result, even though the non-US equity allocation is being reduced, the allocation to emerging market equities will increase. We expect that the long-term growth in emerging markets will surpass that of the developed world. Since emerging market valuations have increased relative to developed markets, we intend to be cautious in the timing of this implementation.
- We intend to continue to manage this portfolio with the support of the four current external advisers. While we believe these four advisers are sufficient to assist us in managing our current allocation, we may need to utilize other advisers and vehicles such as ETFs due to capacity limitations with some of our advisers.

Public Fixed Income – US Long-Term/Core

- We propose to continue to increase the allocation to investment grade fixed income for FY2010-2011. While the yield spread between investment grade corporate and high yield bonds relative to government bonds has narrowed dramatically from the near-record levels of late 2008 and early 2009, in some sectors we believe these remain attractive on a risk-adjusted basis relative to US Treasuries, Agencies, and Asset-Backed securities.
- We will continue to be underweight Financials due to concerns about the credit risk of regional banks and certain financial service companies. We anticipate being less constructive on the longer-end of the curve, particularly within Treasuries, than we have during the past two years due to concerns about the likelihood of significantly higher rates over the next several months. However, we will continue to utilize the Barclays Long Government/Credit Index as the benchmark for our fixed income portfolio, as long-term bonds are highly correlated with the pension funds' long-term liabilities, and thereby reduce the Plan's surplus risk.
- The fixed income portfolio's duration is currently about 10.5 years vs. 12.2 years for the benchmark. We are focused on increasing this duration to better align with our long-term liabilities, while evaluating the timing for duration increases against interest rates, particularly at their current range.
- One attractive segment of the fixed income market is Build America Bonds ("BABs"), which are typically issued in long-duration maturities. These represent taxable municipal bonds with imbedded tax subsidies issued as part of the American Recovery and Reinvestment Act signed in February 2009. These bonds carry attractive yields relative to comparable government bonds. Taxable municipal bonds have consistently offered more yield than similarly rated corporate bonds and have experienced much lower defaults than corporate issuers with the same credit rating. While there is some credit risk related to the issuers, we believe this is less than many segments of the corporate and asset-backed market, making the risk-adjusted yield spread attractive. Additionally, relatively large issue sizes and good liquidity make it possible for the Division to adjust exposure quickly.

Public Fixed Income – International

- We are not recommending an allocation to international fixed income, although we still retain the capability to invest in international bonds if we believe they offer value relative to US fixed income.

Public Fixed Income – US High Yield

- The portfolio consists of various bank loan funds previously classified as private equity or hedge funds, along with direct high yield portfolios managed with the support of external advisers. We do not anticipate significantly increasing our exposure to levered loans as spreads relative to junior bonds have narrowed dramatically over the past year.
- During 2008-2009 we funded a new high yield portfolio with the support of four external advisers. We do not anticipate any significant changes to the high yield allocation over the next several months: yield spreads relative to investment grade bonds have narrowed dramatically but they still remain attractive on an historical basis.
- Our current return expectation for High Yield Fixed Income has decreased by 160 bps from the FY2009 investment plan (from 8.0% to 6.4%), reflecting the dramatic widening of high yield spreads since that time. However, this still represents a spread of 140 bps over core fixed income and 90 bps over long-duration fixed income. We expect default rates to continue to decrease, to average historical levels. Due to these attractive yields, we will maintain or increase our high yield exposure.
- We continue to explore whole loan and other structured credit opportunities to capitalize on perceived dislocations in the markets for these opportunities.

Inflation-Sensitive Assets – Commodities

- Of the current 4% allocation, 2-3% is expected to be invested in commodity-linked investments and 1-2% will be evaluated for possible allocation to infrastructure and other real return investments.
- For commodities, about 1.1% of the Fund (as of January 31, 2010) is invested in funds managed by Gresham and Schroders. We have been working hard to finalize the process of investing an additional 0.65% of the portfolio in a total return swap investment managed by Cargill. Due to issues relating to finalizing the ISDA agreement, we are now seeking other ways to gain commodities related exposure, perhaps through the use of commodity-linked notes and ETFs. We have used both strategies in the past for this purpose.
- We are in the process of developing an Infrastructure Investment Policy with the assistance of one of our consultants and have conducted an extensive RFI for identifying various infrastructure investment opportunities. Since the market turmoil of 2008, however, deal flow has slowed dramatically and the use of leverage has fallen. As a result, this process has been put on hold for now. In the meantime, we funded a \$300 million portfolio (representing about 0.4% of the

Fund) of public infrastructure related equities to gain some exposure to this space. If we are satisfied with the results of this strategy, we may decide to increase this portfolio should private infrastructure opportunities not improve considerably.

Inflation-Sensitive Assets – Treasury Inflation-Protected Securities (TIPS)

- We are maintaining our 5% allocation to TIPS. The portfolio will continue to be internally managed. Given continued concerns about inflation risk resulting from the extraordinary fiscal and monetary stimulus measures over the past two years, we would prefer to own TIPS rather than nominal Treasuries at the back end of the yield curve. Should the attractiveness of TIPS relative to nominal bonds change, we may elect to use TIPS, rather than nominal bonds, as a source of funds for new Commodity-related and Real Assets investments.
- Over the past year, expected TIPS returns have dropped from 5.2% to 4.1%, which is in line with market-duration core bonds due to lower yields across the fixed income market. TIPS continue to price in a significantly lower break-even inflation rate than the Blue Chip consensus forecast, contributing to their attractiveness.

Alternative Investments – Private Equity

- Total planned commitments range from approximately \$0.0 million to \$700 million for the next 15 months, vs. \$1.2 billion planned for the 2009 fiscal year and \$3.1 billion in FY08. Unfunded private equity commitments currently total \$4.6 billion as of 09/30/09; we are projecting that \$1.7 billion of this amount will be called between now and the end of FY2011.
- Therefore, despite the \$1.2 billion planned for FY 2009, no new private equity commitments have been made since November 2008. We are utilizing this broad range of planned commitments because invested capital may exceed the 7% private equity limitation over the next two years but an increase in the market value of the Fund may provide room for a higher level of commitments. All else equal, we would like to be able to take advantage of today's more attractive valuation environment, but recognize our ability to fund new commitments is constrained by the asset class limitation, total pension fund value and the liquidity to honor our existing private equity commitments.
- If any new private equity commitments are completed between now and the end of FY2011, \$150 million would represent the low end of the spectrum for commitments, which would primarily focus on opportunistic investments. At the upper end, we would anticipate funding a number of strategies, including re-ups with attractive existing GPs, debt-related investments and potentially international GPs.

- According to the NJDOI Director's Report for January 2010, the portfolio has an adjusted fair value of roughly \$3.6 billion, or 5.4% of the overall portfolio.

Alternative Investments – Real Estate

- Projected real estate commitments during FY2010-2011 are up to \$450 million, down from \$500 million that had originally been planned for FY2009, though no new commitments have been made since November 2008. We are reducing the midpoint real estate allocation from 4.0% to 3.0%, though the current real estate allocation is only \$1.7 billion, or 2.5% of the Fund.
- If any new real estate commitments are completed between now and the end of FY2011, we believe core opportunities with low leverage and distressed investments to be pursued on an opportunistic basis are most attractive. CMBS and distressed whole-loan investments made by existing managers should pick up in this environment. While much of the real estate market continues to experience distress, we believe valuations, broadly speaking, may have bottomed.
- Unfunded real estate commitments currently total \$1.5 billion, as of 9/30/09; we are projecting about \$1.2 billion in capital calls through FY2011. We are projecting a total real estate market value of \$2.0 billion at the end of FY2010 and \$2.9 billion at the end of FY2011. This increase will be primarily comprised of capital calls from existing investments, modest market appreciation during FY2011 (none during the remainder of FY2010), and \$450 million in new commitments during FY2011 (none during the remainder of FY2010). We may elect to accelerate the pace of commitments towards the back-end of this Annual Plan should market conditions warrant moving towards the upper end of the allocation range.

Alternative Investments – Hedge Funds

- We have increased our hedge fund return expectation from our last annual plan, from 6.5% to 7.0%, due to an anticipated funding of new global macro strategies, which should enhance the returns of the hedge fund portfolio, a gradual increase in leverage, and a pick-up in event-driven investment opportunities.
- We believe the capital markets over the next several months will be choppy and valuations range-bound, which should provide a lucrative environment for hedge fund strategies. In addition, we view hedge fund strategies as a way to reduce the volatility of our public equity and fixed income investments should market conditions deteriorate. As a result, we are increasing our minimum hedge fund allocation from 5.0% to 6.75%; note the current hedge fund allocation is \$2.9 billion, or 4.3% of the Fund. The hedge fund program should provide enhanced

returns relative to fixed income investments and should also provide capital preservation should equity markets correct.

- New hedge fund commitments are expected to be concentrated within newly funded Market Neutral and Global Macro strategies, an increase in the allocation to Event-Driven strategies, and a reallocation towards new managers within Equity Long/Short. As the hedge fund portfolio increases in size, we will need to rebalance investment allocations to the various strategies to optimize the portfolio's risk-return profile.